

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

Consolidated Appeals:
77-5019, 77-5022

77-5019

3/13/78

United States Court of Appeals

For the Second Circuit

In the Matter of

STIRLING HOMEX CORPORATION, *Debtor*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for Mark Goldberg, and Mrs. D. WINDSOR DIXON,

Appellants,

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; and THE TRAVELERS INDEMNITY COMPANY,

Appellees.

Appeal from the United States District Court
for the Western District of New York

APPELLANTS' REPLY BRIEF

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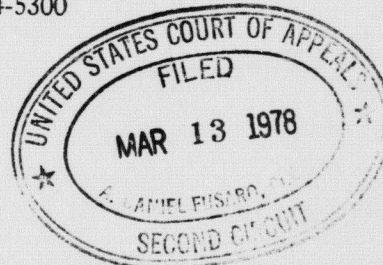


TABLE OF CONTENTS

	<u>Page</u>
1. Stockholders' fraud claims, although "unliquidated or contingent", are now undeniably meritorious, as well as easily provable.....	2
II. Chapter X's expansive provisions for the proof and allowance of claims are controlling notwithstanding that the contemplated reorganization plan will not continue the debtor in business.....	6
III. The modern authorities favor parity treatment of claims of defrauded stockholders.....	8
IV. Stockholders' fraud claims are not disfavored by any special equities or other elements in this case.....	13
A. Laches; non-participation in proceedings leading to settlement with the banks.....	13
B. "Straddling tactics".....	16
C. Remedies against third parties.....	17
D. Conditions for defrauded stockholders' participation in other reorganizations....	18
E. Extent of banks' reliance on debtor's contributed capital.....	19
V. The economic assumptions and theories advanced for subordination of stockholders' fraud claims, as a matter of general policy, are untried and unproven. Such speculations are not a proper basis for judicial decision.....	22

VI.	If the order below is reversed and the case is remanded for reclassification of the claims of defrauded stockholders, the District Court should be instructed to receive evidence in support of equitable subordination of the banks' claims.....	23
VII.	Claims of defrauded stockholders are unaffected by the December 11, 1972 bar order.....	25
VIII.	Jones and Goldberg have standing to appeal, but the question of their standing (raised by Chemical Bank) is academic inasmuch as they are only two of the five appellants.....	28
	Conclusion.....	29

TABLE OF CITATIONS

	<u>Page</u>
<u>Cases:</u>	
American Loan & Finance Co., E.D. Va. No. 508-72-N.....	18
Bankers Life and Casualty Company v. Kirtley, 338 F. 2d 1006 (8th Cir. 1964).....	7
Carter v. Bogden, 13 F. 2d 90 (8th Cir. 1926).....	10
Cartridge Television, Inc., Matter of, 535 F. 2d 1388 (2d Cir. 1976).....	5, 8
Central States Electric Corp. v. Austrian, 183 F. 2d 879 (4th Cir. 1950), cert. den. 340 U.S. 917 (1951).....	6
City of New York v. New York, New Haven & Hartford Railroad Co., 344 U.S. 293 (1953).....	13
Credit Industrial Corp., In re, 366 F. 2d 402 (2d Cir. 1966).....	8
Dolly Madison Industries, Inc., E.D. Pa. No. 70-354.....	18
Equity Funding Corp. of America, Matter of, 416 F. Supp. 132 (C.D. Calif. 1975).....	8, 11, 18
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).....	17
Farrington Mfg. Co., E.D. Va. No. 17-71-A.....	18
F.D.I.C. v. American Bank Trust Shares, Inc., 412 F. Supp. 302 (D. So.Car. 1976), vacated and remanded, other issues, 558 F. 2d 711 (4th Cir. 1977).....	10
Four Seasons Nursing Centers of America, Inc., In re, 472 F. 2d 747 (10th Cir. 1973).....	8, 11
Green v. Brown, 398 F. 2d 1006 (2d Cir. 1968).....	23

<u>Cases (continued):</u>	<u>Page</u>
Groenleer-Vance Furniture Co., In re, 23 F. Supp. 713 (W.D. Mich. 1938).....	10
Harbor Tank Storage Co., In re, 385 F. 2d 111 (3rd Cir. 1967).....	14
Intaco Puerto Rico, Inc., In re, 494 F. 2d 94 (1st Cir. 1974).....	14
Jezarian v. Csapo, U.S.D.C. S.D.N.Y. 72 Civ. 1671 (DBB).....	24
Kelce v. U.S. Financial, Inc., 3 Bankr. Ct. Dec. 507 (S.D. Calif. 1977).....	10
Krause v. Sacramento Inn, 479 F. 2d 988 (9th Cir. 1973).....	23
Los Angeles Land and Investments, Ltd., In re, 282 F. Supp. 448 (D. Hawaii 1968), aff'd 447 F. 2d 1366 (9th Cir. 1971).....	8
Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928).....	23
Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206 (1937).....	8, 10
Protective Committee for Independent Stock- holders of TMT Trailer Ferry, Inc. v. Anderson, 364 F. 2d 936 (5th Cir. 1966), rev'd other grounds, 390 U.S. 414 (1967).....	26
Schenfeld v. Norton Co., 391 F. 2d 420 (10th Cir. 1968).....	23
Scott v. Abbott, 160 Fed. 573 (8th Cir.), cert. den. 212 U.S. 571 (1908).....	9, 10
Singleton v. Wulff, 428 U.S. 106 (1976).....	23
U.S.A. v. David Stirling, Jr., et al., Docket No. 77-1140 (2d Cir. 2/2/78).....	2, 3, 17

	<u>Page</u>
<u>Statutes and Rules:</u>	
<u>Bankruptcy Act</u>	
§ 57(d), 11 U.S.C. § 93(d).....	5
§ 63, 11 U.S.C. § 103.....	6
§ 106, 11 U.S.C. § 506.....	3, 6, 7
§ 216(10), 11 U.S.C. § 616(10).....	6
§ 236, 11 U.S.C. § 636.....	7
<u>Chapter X Rules</u>	
10-209.....	27
10-308.....	7
<u>Bankruptcy Rule</u>	
122.....	7
<u>Miscellaneous:</u>	
6A Collier on Bankruptcy, pp. 412-456.....	7
Congressional Battle over Bankruptcy, N. Y. Times, 3/5/78, § 3, p. 1.....	22
V. Countryman, Problem Areas in Chapter X and XI Cases, as contained in Bankruptcy and the Chapter Proceedings, published by the Institute of Continuing Legal Education (1976).....	9
M. Huff, The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5, 50 Am. Bankr. L.J. 197 (1976).....	9
Shepard's Federal Citations.....	9
J.J. Slain and H. Kripke, The Interface Between Securities Regulation and Bankruptcy - Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors, 48 N.Y.U. L.R. 261 (1973).....	9, 19
<u>Congressional Materials:</u>	
Bankruptcy Reform Act, H.R. 8200.....	22
Bankruptcy Reform Act, S. 2266.....	22
Report of House Committee on the Judiciary, H.R. Rep. No. 95-595, 95th Cong., 1st Sess., (1977).....	9

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Appellees.

Appeal from the United States District Court
for the Western District of New York

APPELLANTS' REPLY BRIEF

We aim, in this reply brief, succinctly to respond
to all the arguments advanced in the several appellees' briefs.

One question, the merit of the stockholders' fraud claims against the debtor, should be altogether dispelled by this Court's affirmance on February 2, 1978 of the convictions of a number of members of former management of securities and mail fraud and conspiracy in connection with sales of the debtor's stock to the public. U.S.A. v. David Stirling, Jr., et al., Docket No. 77-1140. We begin by noting that ruling's implications for the appeals at bar.

I.

STOCKHOLDERS' FRAUD CLAIMS,
ALTHOUGH "UNLIQUIDATED OR
CONTINGENT", ARE NOW UN-
DENIABLY MERITORIOUS, AS
WELL AS EASILY PROVABLE.

As observed in our main brief, p. 7, the only theme in Judge Burke's opinion by way of factual basis for his subordination ruling is the supposedly uncertain and litigable character of the stockholders' fraud claims. This finding, of course, will not stand with the Trustee's § 167 report, the detailed findings of the Securities and Exchange Commission and other material in the record¹ which our adversaries, like

1. See our main brief, pp. 7-11.

Judge Burke, have completely ignored.²

We dispute that the District Judge had discretion to reject claims by reason of uncertainty of merit or difficulties of proof; our main br. p. 31, citing Bankruptcy Act § 106, 11 U.S.C. § 506. Even assuming the existence of such discretion, however, this point should detain us no longer. Since the filing of our main brief, the Court has affirmed the convictions of David Stirling, Jr. and four other principal officers of the debtor for defrauding public investors in the sale of Stirling Homex securities. U.S.A. v. David Stirling, Jr., et al, Docket No. 77-1140, decided February 2, 1978. The Court concluded, slip op. at p. 1407:

2. Chemical Bank's brief, p. 20, claims that the wisdom of Judge Burke's discretionary subordination of stockholders' fraud claims appears from the fact that "The class actions antedate the Chapter X proceedings and are still only in their discovery stage." This suggestion (also to be found in the Trustee's brief, pp. 11, 28, and in The Travelers' brief, p. 7) is all that appellees offer to support Judge Burke's conclusion as to the dubiety of the claims in question.

The Bank (which is a class action defendant) neglects to mention that the class suit is untried only because of inability, pending final disposition of U.S.A. v. David Stirling, Jr., et al., supra, to obtain the testimony of key members of former management, defendants therein, who so far have been standing on their Fifth Amendment privileges. The debtor's former auditors and its investment banker, leading defendants in the class suit, have successfully urged that they should not have to stand trial without that testimony, in aid of their defense of want of scienter. Since that defense is unavailable to the debtor, the delay in trial of the class action has no bearing whatsoever on the merits and provability of stockholders' fraud claims against the debtor.

"The record shows that appellants engaged collectively in a calculated and multifaceted plan to give the investing public the false impression that Homex was in a sound and steadily improving financial position and at the same time withhold adverse information that was material to an accurate appraisal of the company's prospects."

Considering that the Trustee has already conceded the pervasive falsity of the debtor's accounting, our main br. p. 8, establishing the debtor's liability to appellants, hence to other stockholders, past and present, should be the next thing to a pro forma exercise. Proof of the damages of individual stockholders likewise should present no problem: We have already shown "that the debtor's stock was worthless at all relevant times";³ this is unchallenged by any of the appellees.

Once the debtor's defrauding of its stockholders and the worthlessness of its stock is established for the record, claims may be fixed by simple proof of claimants' transactions in Stirling Homex shares - in most instances merely by attachment of brokers' trading confirmations or similar documentation to the claim forms. Even in ordinary

3. See our main brief, p. 11.

bankruptcy, where the court has discretion to disallow unliquidated or contingent claims, Bankruptcy Act § 57(d), 11 U.S.C. § 93(d), rejection of "an easily provable securities fraud claim ... might well amount to an abuse of discretion." Matter of Cartridge Television, Inc. 535 F. 2d 1388, 1391 (2d Cir. 1976). We find it hard to envisage more "easily provable securities fraud claim[s]" than the ones at bar.

II.

CHAPTER X's EXPANSIVE PROVISIONS FOR THE PROOF AND ALLOWANCE OF CLAIMS ARE CONTROLLING NOTWITHSTANDING THAT THE CONTEMPLATED REORGANIZATION PLAN WILL NOT CONTINUE THE DEBTOR IN BUSINESS.

Chemical Bank's brief, pp. 16-21, urges that stockholders' fraud claims were properly rejected, as unprovable intentional tort claims under § 63 of the Act, 11 U.S.C. § 103, even though § 63 is explicitly rendered inapplicable in Chapter X proceedings by the Chapter's expansive definitions of claims and creditor, contained in § 106, 11 U.S.C. § 506. The same argument, although in more abbreviated compass, is made by the Trustee, br. pp. 18, 23; by Chase Bank, br. Pt. II; and by The Travelers, br. p. 7.

The contention defies the structure as well as the explicit provisions of the Act. A liquidation-reorganization is specifically sanctioned by § 216(10), 11 U.S.C. § 616(10), of Chapter X.⁴ While this proceeding might have been converted

4. Chemical Bank, br. p. 17, claims that a § 216(10) liquidation "has as its underlying rationale, the effort to realize going concern values of assets for creditors and perhaps stockholders." Assuming this to be so, this Chapter X proceeding, now approaching its sixth year, surely meets that goal: The present condition of the debtor's estate is the result of the Trustee's painstaking efforts to squeeze dry every asset, the antithesis of the forced sales which are the hallmark of ordinary bankruptcy. See the Trustee's § 167 report, pp. 7-9, A 161-3; see also A 200-2.

"[I]t is well recognized that eventual liquidation may be a proper purpose of reorganization." Central States Electric Corp. v. Austrian, 183 F. 2d 879, 883 (4th Cir. 1950), cert. den. 340 U.S. 917 (1951).

to ordinary bankruptcy under § 236, 11 U.S.C. § 636, and Chapter X Rule 10-308, conversion would have mandated compliance with Bankruptcy Rule 122. The Trustee and the conventional creditors eschewed that route.⁵ They may not now have it both ways, just to defeat claims of defrauded stockholder-creditors.

Our adversaries cite no authority, and we find none, for rendering § 106 a dead letter because the Chapter X plan will not continue the debtor in business. A like argument was advanced and flatly rejected in Bankers Life and Casualty Company v. Kirtley, 338 F. 2d 1006, 1009-10 (8th Cir. 1964).

⁵. For an indication of the complications, expense and delay incident to conversion from reorganization under Chapter X to straight bankruptcy under Chapters I-VII, see 6A Collier on Bankruptcy, pp. 412-456.

III.

THE MODERN AUTHORITIES FAVOR PARITY TREATMENT OF CLAIMS OF DEFRAUDED STOCKHOLDERS.

We are castigated by the Trustee, br. pp. 5-6, who is echoed by Chemical Bank, br. p. 24, for assertions in our main brief that case law uniformly supports parity treatment for defrauded stockholders. According to the Trustee, br. p. 6: "Counsel does not cite a single bankruptcy case or authority in support of these unfortunate and erroneous statements."

We cited, main br. pp. 27-9, seven decisions in support of our position. Five were bankruptcy cases decided within the last dozen years⁶ and of those, three were Chapter X reorganizations.⁷ A sixth citation, Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206 (1937), although not a bankruptcy case, is generally recognized as a

6. In re Credit Industrial Corp., 366 F. 2d 402 (2d Cir. 1966); Matter of Cartridge Television, Inc., 535 F. 2d 1388 (2d Cir. 1976); In re Four Seasons Nursing Centers of America, Inc., 472 F. 2d 747 (10th Cir. 1973); Matter of Equity Funding Corp. of America, 416 F. Supp. 132 (C.D. Calif. 1975); In re Los Angeles Land and Investments, Ltd., 282 F. Supp. 448, 453-4 (D. Hawaii 1968), aff'd 447 F. 2d 1366 (9th Cir. 1971).

7. Four Seasons, Equity Funding and Los Angeles Land and Investments.

highly pertinent, if not the leading, authority on the issue.⁸ This Court, needless to say, will draw its own conclusions as to the aptness of our citations; and we will not restate these cases here.

The Trustee, for his part, br. pp. 4-5, cites only one decision which fairly qualifies as a case in point, Scott v. Abbott, 160 Fed. 573 (8th Cir.), cert. den. 212 U.S. 571 (1908). According to Shepard's Federal Citations, this hoary ruling was last cited some forty years ago⁹ and then on another issue. The rationale of Scott, commencing with the sentence quoted by the Trustee at page 5 of his brief, is that defrauded shareholders, even though innocent of the debtor's fraud, may not assert their claims at the expense of other creditors because the guilty officers of the debtor were, ex officio, the agents of the defrauded stockholders. Hence, the court concluded (at p. 583), the stockholders "are estopped from asserting their claims against the right of the

8. See, e.g., Report of the House Committee on the Judiciary on a bill to revise the Bankruptcy Act, cited at p. 34, fn. 19 of our main brief; V. Countryman, Problem Areas in Chapter X and XI Cases, 259, at 270, as contained in Bankruptcy and the Chapter Proceedings, published by the Institute of Continuing Legal Education (1976); J.J. Slain & H. Kripke, The Interface between Securities Regulation and Bankruptcy, etc., 48 N.Y.U. L.R. 261, 268-72 (1973); M. Huff, The Defrauded Investor in Chapter X Reorganizations, etc., 50 Am. Bankr. L.J. 197, 210-14, 218 (1976).

9. In 85 F. 2d at 74.

general creditors who acted to their prejudice upon the representations made by the agents of appellants and the other stockholders." This reasoning was implicitly overruled by Oppenheimer's holding, 301 U.S. at 215:

"And as claimants they [i.e., stockholders] stand on the same footing as other creditors. Discrimination against their claims is not authorized by the statute." [footnote omitted.]

True, Oppenheimer arose under the Bank Act; but Scott's tainting of defrauded stockholders with the offenses of management on an agency theory cannot be attributed to any peculiarity of bankruptcy law.

Of the Trustee's other citations which we are charged with overlooking: F.D.I.C. v. American Bank Trust Shares, Inc., 412 F. Supp. 302 (D.So.Car. 1976), vacated and remanded, other issues, 558 F. 2d 711 (4th Cir. 1977), was a receivership, not a bankruptcy; and it dealt with priority of suit rather than distribution of assets. Carter v. Bogden, 13 F. 2d 90 (8th Cir. 1926), a straight bankruptcy, subordinated the claimant-stockholder to general creditors because he had rendered the debtor insolvent at its inception by selling the debtor his business for a grossly excessive price. In re Groenleer-Vance Furniture Co., 23 F. Supp. 713 (W.D. Mich. 1938), also a bankruptcy, involved a stockholder-claimant held to be chargeable with the alleged fraud.

Chase Bank, br. pp. 7-8, relies on Kelce v. U.S. Financial, Inc., 3 Bankr. Ct. Dec. 507 (S.D. Calif. 1977).

In that case a bankruptcy judge denied senior or preferred creditor status to an allegedly defrauded stockholder seeking recovery, by rescission and reclamation, of real estate which he had given in exchange for his stock. We read the decision, which, however, is not a model of lucidity, as an authority for appellants because, notwithstanding "the hopeless insolvency" of the debtor, the creditor was relegated to participation in the plan on a parity with other stock fraud claimants:

"If he can establish his fraud claim, he would then fall into the class with all other stock fraud claimants and, under the terms of the plan which has been approved in this case, would share pro rata with those claimants."

In our main brief, p. 29, we cited In re Four Seasons Nursing Centers of America, Inc., 472 F. 2d 747 (10th Cir. 1973), and Matter of Equity Funding Corp. of America, 416 F. Supp. 132 (C.D. Calif. 1975), for their recognition of the viability of parity claims of defrauded stockholders in order to justify their participation, through partial allowance, in reorganization plans under Chapter X. Chemical Bank, br. pp. 26-7, disparages these citations with the observation that if defrauded stockholders were entitled to parity treatment as we contend, nothing less than full parity treatment should have been sanctioned. This reasoning, however, runs both

ways: If our adversaries correctly urge that subordination is mandated, those cases should have rejected any participation by the defrauded stockholders as unfair to conventional creditors.

Chase Bank, br. p. 7, and Chemical Bank, br. p. 15, invoke the absolute priority rule. In the case of stockholders it so far has been applied only with regard to their equity interests. We find no instance of its application to a stockholder's fraud claim - let alone to the fraud claim of a past stockholder who has no equity status to be "elevated" in a supposed circumvention of the absolute priority rule.

IV.

STOCKHOLDERS' FRAUD CLAIMS ARE
NOT DISFAVORED BY ANY SPECIAL
EQUITIES OR OTHER ELEMENTS IN
THIS CASE.

A. Laches; non-participation in proceedings
leading to settlement with the banks.

Although the Trustee, br. p. 29, continues to disclaim reliance on the December 11, 1972 bar order, A 24, his brief, pp. 9-10, 21-2, faults appellants and their counsel for "belated intrusion" in the proceeding and for seeking to "dilute the distribution to small suppliers and workers." In similar vein, Chemical Bank, br. pp. 29-30, and The Travelers, br. pp. 8-9, charge appellants with laches.

We have difficulty comprehending these arguments. Putting aside the 1972 bar order, it was neither incumbent upon nor even appropriate for defrauded stockholders to file or otherwise announce their claims, pending their solicitation. As held in City of New York v. New York, New Haven & Hartford Railroad Co., 344 U.S. 293, 297 (1953):

"But even creditors who have knowledge of a reorganization have a right to assume that the statutory 'reasonable notice' will be given them before their claims are forever barred."

Until their claims are solicited, creditors, regardless of their familiarity with the reorganization proceeding, are

in no way obliged to participate, whether by filing claims or otherwise. Thus in In re Harbor Tank Storage Co., 385 F. 2d 111, 115 (3rd Cir. 1967):

"And the fact that a creditor knows of the initiation of reorganization proceedings does not of itself place a burden on the creditor to file an appearance or claim in the proceeding before receiving notice to do so: a creditor has every right to assume that he will be sent all the notices to which he is entitled under the Act."

To the same effect is In re Intaco Puerto Rico, Inc., 494 F. 2d 94, 99 (1st Cir. 1974):

"Moreover, the fact that the creditor may, as here, be generally aware of the pending reorganization, does not of itself impose upon him an affirmative burden to intervene in that matter and present his claim. The trustee can not avoid his statutory responsibility under Chapter X, to formally provide the required notice, simply because of a creditor's possible familiarity with general aspects of the proceedings. As the Supreme Court has stated, the creditor has a right to assume that proper and adequate notice will be provided before his claims are forever barred." [footnote omitted.]

The Trustee's brief, p. 21, nonetheless complains that "none of [appellants] appeared in person or by counsel" in the proceeding respecting his settlement with the banks. Appellants should have appeared to do what? The Trustee and the several appellees and their able counsel surely did not need appellants' help to construe the 1972 bar order and assess the reach of its mode of service.

The settlement with the banks guards them against additional general as well as priority claims, at the expense of all other general creditors, A 56, ¶ 3.2 - including the "small suppliers and workers", The Travelers and the defrauded shareholders. The fairness of the settlement, which earmarks at least 76% of the distributable assets for the banks,¹⁰ depended, it seems to us, more on the strength of the banks' claims as lienors than on the totality of claims of other creditors.¹¹ Be that as it may, we fail to see, if it now develops that distributions to non-bank creditors will be inordinately small as our adversaries complain, how the Trustee and other involved parties can sensibly shift the blame to the defrauded stockholders, even to the point of depriving them of all interest in the distributable assets.

The Trustee would have it that appellants' counsel engaged in some sort of entrapment. Thus, in a footnote at page 22 of his brief: "The letter [from appellants' counsel to the Trustee, A 412] reveals the fact that counsel for the

10. See our main brief, p. 20, fn. 12.

11. The settlement cannot be evaluated from the record of the proceedings leading to its approval, A 52-145, because the record does not set forth any of the operative facts or points of law which presumably were in issue between the Trustee and the banks but only the most general and conclusory assertions as to the nature of the controversy and the rationale of the compromise. No evidence was received or proffered except for the credit agreement with the banks, A 79, their proofs of claim, A 104-5, and a schedule estimating distributable cash at the conclusion of the liquidation, A 95.

so-called defrauded stockholders, notice or no notice, was closely following the bankruptcy proceedings and had full and complete knowledge concerning them." The letter reveals nothing of the kind and the asserted "fact" is untrue. The letter, A 412, followed several discussions with the Trustee which appellants' counsel initiated after reading press reports of the Trustee's settlement with the banks and of the substantial assets which thereby were freed for distribution to general creditors.

B. "Straddling tactics".

According to the Trustee, br. pp. 13-14, stockholders have been waiting for over five years to decide whether to claim against the debtor as creditors or to assert their interests as equity owners. They decided to claim as creditors, the Trustee tells us, only when it became apparent that the debtor could not be rehabilitated and had to be liquidated. Another virtue of subordination of claims of defrauded stockholders, according to the Trustee, is the prevention of such "straddling tactics".

According to Chemical Bank, br. p. 18, on the other hand, this proceeding "in reality, has been nothing more than a liquidation since the day the Chapter X petition was filed." This statement jibes with the Trustee's own § 167 report, A 154.

Appellants' alleged "straddling tactics" are a fantasy. The debtor at all times has been hopelessly insolvent and beyond rehabilitation. Stockholders, past and present, had no duty or occasion to act until their proofs of claim or equity interests were solicited, which has yet to occur. Moreover, past stockholders, once they parted with their shares, which very many did in advance of the bankruptcy, had only claims and no equity interests on which to "straddle", even accepting the Trustee's premises.

C. Remedies against third parties.

Chase Bank, br. p. 10, and the Trustee, br. p. 14, argue that the defrauded stockholders are pursuing remedies under the Securities Acts against members of former management and others which are unavailable to the remaining creditors, on which account defrauded stockholders should accept a junior position. Why equivalent remedies are not available to the banks¹² and other conventional creditors, they do not tell us. Appellants' Securities Act claims against third parties also may present problems as to scienter,¹³ as previously noted, as well as of collectibility,

12. Marine Midland, br. pp. 4-5, submits "that Homex's commercial bankers ... were actually among its principal victims", and cites a passage from U.S.A. v. David Stirling, Jr., et al., supra, to the effect that the banks were targets of "the most blatant misrepresentation in the entire Homex drama."

13. See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

especially as regards the individuals who stand convicted in the criminal case.

D. Conditions for defrauded stockholders' participation in other reorganizations.

Our main brief, p. 12, fn. 4, cited seven recent bankruptcy reorganizations of public companies wherein participation by defrauded stockholders was achieved by consent. None of those reorganizations, says the Trustee, br. pp. 12-13, was a liquidation, and in all of them the participation accorded defrauded stockholders was at the expense of other stockholders of the debtor.

According to our information, the Trustee is incorrect to this extent: (1) American Loan & Finance Co. and Farrington Mfg. Co. were liquidations; and (2) the stock received by defrauded shareholders in Dolly Madison Industries and Equity Funding¹⁴ and the cash received by defrauded shareholders in American Loan & Finance and Farrington were at the expense of creditors.

14. See Matter of Equity Funding Corp. of America, 416 F. Supp. 132, 150-2 (C.D. Calif. 1975).

E. Extent of banks' reliance on debtor's contributed capital.

Point II of our main brief, as explained in its opening paragraph on page 37, postulated that the Court might reject parity treatment for defrauded stockholders as a general proposition, giving weight to the Slain/Kripke article, Interface between Securities Regulation, etc., 48 N.Y.U. L.R. 261 (1973). We argued that parity treatment would nonetheless be appropriate for the defrauded stockholders of Stirling Homex, vis-a-vis its bankers, because the centerpiece of the Slain/Kripke thesis is the conventional creditors' reliance, in fact, on a cushion of capital contributed by the stockholders. The present bank creditors, we said, cannot demonstrate any such reliance.

Some of our adversaries are less than candid in addressing this contention.

The Trustee, br. p. 26, has it that "the new loans which gave rise to the banks' claims herein were made in January of 1972 (A.81)." The appendix citation in no way supports this statement. Similarly, Marine Midland, br. p. 4, alludes to the credit agreement between the debtor and the banks which was dated January 24, 1972, implying that the banks' loans were effected on or about that date. In actuality, according to the Trustee's § 167 report, A 158, "Coincident with the public offering [i.e., the preferred stock offering of July 29, 1971],

Debtor borrowed heavily, establishing a \$55 million line of credit and actually borrowing \$38 million over an extended period of time." As indicated by Chase Bank, br. p. 2, the agreement of January 24, 1972 was intended to perfect the banks' liens against the assets of the debtor by way of security for uncollateralized loans already outstanding.¹⁵

Several of our adversaries do not read what passed between officers of Chemical Bank and representatives of Merrill Lynch, Pierce, Fenner & Smith at a meeting which preceded the July 29, 1971 preferred stock offering, as set forth at pages 40-1 of our main brief, as an assurance that the banks would continue to extend credit to the debtor, regardless of the outcome of the preferred stock offering. The Court will draw its own conclusion noting, we suggest, that the quoted narrative, from an attorney's affidavit, stands uncontradicted in the present record.

By way of underlining the banks' non-reliance on the debtor's contributed capital, we also observed, main br. p. 41, that at least until the banks allegedly perfected their liens, they were lending, on an unsecured basis, in the extraordinary ratio of debt to capital of 74%. In their way, we argued, the

15. At a hearing before Bankruptcy Judge Hayes on the settlement with the banks, the Trustee, A 76-8, sketched the history of the bank loans, concluding that the credit agreement of January 24, 1972 was intended merely to effect "a change from an unsecured to a secured position."

The January 1972 agreement was anticipated in the prospectus for the July 29, 1971 preferred stock offering, at which time the banks had lent the debtor \$37 million without security. A 272; A 348, last ¶; A 354, last ¶.

banks were speculating on the debtor's viability in no less degree than the stockholders. The following, in Chase Bank's brief, p. 8, supports our thesis:

"In deciding whether or not to extend credit to a public corporation, the potential creditor weighs the possibility of the debtor's possible bankruptcy in his decisional calculus. The creditor often inspects the debtor's debt-to-equity ratio to ascertain whether an adequate 'cushion' of equity exists so as to minimize his risk of loss. Thus, the creditor will extend credit in the belief that his claim will be satisfied before that of stockholders in the event of the debtor's insolvency." [underscoring added.]

The bank-creditors in this case either avoided the usual inspection of Homex's debt-to-equity ratio, or else they chose to ignore the gross inadequacy of its "'cushion' of equity." Why, then, should the banks be preferred to the defrauded stockholders, on the theory that the banks relied on the debtor's contributed capital?

It is incorrect, as asserted by the Trustee, br. p. 25, that we did not urge this point in the court below. The factual predicates for the argument were introduced through the affidavit of appellants' counsel; see A 272, 1st two double spaced paragraphs. The point was also made, albeit briefly, in appellants' post-hearing memorandum, at p. 14.

V.

THE ECONOMIC ASSUMPTIONS AND THEORIES
ADVANCED FOR SUBORDINATION OF STOCK-
HOLDERS' FRAUD CLAIMS, AS A MATTER OF
GENERAL POLICY, ARE UNTRIED AND UN-
PROVEN. SUCH SPECULATIONS ARE NOT A
PROPER BASIS FOR JUDICIAL DECISION.

Chase Bank, br. pp. 8-9, is concerned that parity treatment for defrauded stockholders could increase the cost of credit. Similar claims are made by other appellants. Judge Burke, A 444, felt that parity treatment would work "a fundamental change in the financial structure of the business community ...".

There are no data to substantiate these fears and speculations. Congress is exploring this area, in considering proposals for revision of the Bankruptcy Act; our main br. p. 34, fn. 19.¹⁶ In our view, it is not for the courts to tinker with statutory and quite settled decisional law on the strength of unsubstantiated economic theories like those advanced by the District Judge and appellees in the matter at bar.

Certain it is that, in a case of this kind, stockholders are as innocent as other creditors of the debtor's fraud. Neither category of creditor bargained to be defrauded. Neither consciously assumed any such risk. Fixing priorities as between such groups of claimants, in response to untested prophecies as to the reaction of the nation's economy, is

16. A subcommittee of the Senate Judiciary Committee expects next month to consider S. 2266 and H.R. 8200; the latter was recently passed by the House. Congressional Battle over Bankruptcy, New York Times, 3/5/78, § 3, p. 1.

no part of the rightful judicial function.¹⁷

VI.

IF THE ORDER BELOW IS REVERSED AND
THE CASE IS REMANDED FOR RECLASSIFI-
CATION OF THE CLAIMS OF DEFRAUDED
STOCKHOLDERS, THE DISTRICT COURT
SHOULD BE INSTRUCTED TO RECEIVE EVI-
DENCE IN SUPPORT OF EQUITABLE
SUBORDINATION OF THE BANKS' CLAIMS.

The alleged facts and argument favoring subordina-
tion of the banks' claims to those of defrauded preferred stock-
holders and certain of the defrauded common stockholders are set
forth at pages 22-3 and pages 43-5 (Point III) of our main brief,
and need not be repeated here.

Our adversaries complain that we did not raise this
issue in the court below. They are correct. We submit, however,
that appellants should not thereby be precluded, in the interest
of justice, because the issue is of high importance to many
persons and because neither the parties nor the bench will in
any way be prejudiced or discommoded if the cause is to be
remanded in any event on other grounds. Singleton v. Wulff,
428 U.S. 106, 121 (1976); Krause v. Sacramento Inn, 479 F. 2d
988, 989-90 (9th Cir. 1973); Green v. Brown, 398 F. 2d 1006,
1009 (2d Cir. 1968); Schenfeld v. Norton Co., 391 F. 2d 420,
424-25 (10th Cir. 1968).

17. Also to be considered, by the same token, is the possible
increased cost of venture capital, if claims of defrauded stock-
holders are invariably to be subordinated to those of other
creditors.

"Such a calculus of probabilities is beyond the science
of the chancery." Meinhard v. Salmon, 249 N.Y. 458, 465,
164 N.E. 545, 547 (1928), per Cardozo, C.J.

Chase Bank, br. p. 15, and Chemical Bank, br. pp. 38-9, contend that the District Court's approval of the Trustee's settlement, with concomitant allowance of the claims of the banks as unsecured claims, A 142-5, is an adjudication which bars the defrauded shareholders from priority status. Appellees, we submit, err on two counts: (1) the claims of defrauded shareholders, not yet having been solicited, were not before the court when it passed upon the settlement with the banks and, as a matter of due process, could not be dealt with at that time; and (2) recognition of the banks as unsecured creditors in no way imported that the banks were entitled to parity treatment as against all other unsecured creditors. Indeed, on the latter point, as already noted, the settlement agreement with the banks, in ¶ 3.2, A 56, itself envisages later priority claims.

The Trustee, br. p. 28, and Chemical Bank, br. p. 38, also argue that, assuming that the banks did defraud the stockholders, instead of seeking to subordinate the banks' claims, they should be satisfied with the prosecution of the third count in Jezarian v. Csapo, A 432-5. Defrauded stockholders, we submit, do not have to make an election as between suing the banks and pressing their claims against the debtor. Furthermore, the only bank-defendant in Jezarian is Chemical Bank,

whose claims against the debtor represent only about 53% of the entirety of the banks' accepted claims. A 167-8.

VII.

CLAIMS OF DEFRAUDED STOCKHOLDERS
ARE UNAFFECTED BY THE DECEMBER 11,
1972 BAR ORDER.

Chemical Bank, Marine Midland and The Travelers all rely heavily on the December 11, 1972 bar order, A 24, as precluding defrauded shareholders at the threshold (except for the six "timely" filers, A 173). Those appellees, along with appellants, pose the effect of the bar order on thus far unfiled claims of defrauded stockholders as a primary question for determination on these appeals. We disagree with the Securities and Exchange Commission, br. pp. 8-9, that the effect of the bar order is not before this Court because Judge Burke did not reach that issue. Judicial economy, moreover, we respectfully submit, calls for this Court's review of the bar order and its mode of service, to determine whether defrauded stockholders have been adequately notified that their claims had to be filed by February 19, 1973, A 24 - should the Court agree with us that Judge Burke has incorrectly rejected all claims of defrauded stockholders.

Among the appellees, only Chemical Bank purports to come to grips with the bar order issue, at pp. 30-34 of its brief, responding to pp. 46-56 (Point IV) of our main brief.

The Bank relies on Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 364 F. 2d 936 (5th Cir. 1966), rev'd other grounds, 390 U.S. 414 (1967), to support its contention that the text of the bar order encompasses stockholders' fraud claims. The Bank's reliance is misplaced: Much the same as the bar order herein, the bar order in Anderson, at p. 939, excepted "'proofs of claims of creditors and/or interest of stockholders ... founded upon securities.'" Anderson, id., found this clause inapplicable to stockholders' fraud claims only because "Other parts of the district court's order had pretty clearly indicated that the exception as to proofs of claim founded upon securities contemplated a contract claim rather than a tort claim or right of rescission." Neither the Anderson opinion nor Chemical Bank quotes or in any way describes such "other parts" of the Anderson bar order. We find no such exception-negating "other parts" in the bar order in our case, and none of our adversaries has ventured to suggest what they might be.

The Bank, br. p. 31, says that we have confused stockholders' "claims" with stockholders' "interests". We thought that we had gone to some lengths to differentiate them, particularly at page 50 of our main brief, in making the point that the bar order herein is completely silent on when proofs of claim - as distinguished from proofs of equity interests - of stockholders have to be filed.

Much of the remainder of the Bank's discussion of the bar order issue is devoted to justifying the mode of service on present stockholders, which appellants never questioned. What appellants question is the omission to mail the bar order to past stockholder-creditors whose names and addresses were readily ascertainable from the debtor's transfer records. On this issue, we fail to understand the Bank's reliance on Rule 10-209: Defrauded past stockholders were entitled to mailed notice by reason of their status, not as stockholders of record (which, of course, they no longer were) but as creditors.

The Trustee, in the concluding paragraphs of his brief, also sets up a straw man: The supposed need "to search for names and addresses of all past stockholders, numbering thousands, to solicit from them claims and process such claims, to say nothing of auditing and litigating them." This, says the Trustee, will be an impossible burden for him since he now employs only three persons.

It is commonplace in stockholders' class actions to cull names and addresses from transfer records in order to send court notices to past, as well as current, security holders. Reasonable effort is all that is required. No one has suggested that the Trustee would have to search out

beneficial owners of securities in "street names"; this is a task for stock brokers and other such custodians.

The detail work in giving notice to past stockholders is easily arranged for with a mailing firm or similar concern, of which there are many with the requisite experience. The \$17 million estate can well afford the expense.

There should be no occasion for "auditing and litigating" the claims in question. Their proof should be quite pro forma; Point I, supra.

VIII.

JONES AND GOLDBERG HAVE STANDING TO APPEAL, BUT THE QUESTION OF THEIR STANDING (RAISED BY CHEMICAL BANK) IS ACADEMIC INASMUCH AS THEY ARE ONLY TWO OF THE FIVE APPELLANTS.

Jones and Goldberg are of the six defrauded stockholders who, according to our adversaries, possess the only claims which were timely filed, our main br. p. 14.

No evidence relating to the classification issue was taken at the hearing leading to the order under review. The present record was made in the post-hearing affidavits, A 269, A 401, and in prior proceedings. At the hearing appellants'

counsel appeared only for the Jezarians and Lonetown Company. A 189. Following the hearing, counsel for the Jezarians and Lonetown was authorized to submit his papers in behalf of Jones and Goldberg as well; and he did so, A 269.

Under Judge Burke's ruling, the claims of Jones and Goldberg were open and undetermined. A 173. The late appearance of Jones and Goldberg, if such it was, has prejudiced no one.

Chemical Bank, br. pp. 34-7, argues at length, however, that Jones and Goldberg have no standing to appeal because of their delayed appearance below. If the order under review is reversed, are Jones and Goldberg alone to be bound by the District Court's erroneous subordination of stockholders' fraud claims, simply because of their delayed appearance, post-hearing? We are unable to discern what the Bank hopes to accomplish by dismissing only Jones and Goldberg of the five appellants. It seems needless to discuss the question further.

CONCLUSION

The order appealed from should be reversed, with directions as previously prayed for.

Dated: New York, New York
March 13, 1978

Respectfully submitted,

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CERTIFICATE OF SERVICE

I am over the age of 18 years and am in the employ of Pomerantz Levy Haudek & Block.

On March 13, 1978 I served the annexed Appellants' Reply Brief on all of the following attorneys for appellees by delivering two copies thereof, each enclosed in a sealed post-paid first-class envelope, to the United States Postal Service in the post office maintained at Lexington Avenue and 45th Street, New York, New York, addressed as follows:

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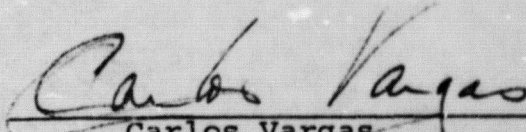
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